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Shaky foundations: Policy lessons from America's historic housing crash

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The Levy Economics Institute of Bard College

Public Policy Brief

No. 95, 2008

SHAKY FOUNDATIONS

Policy Lessons from America's Historic
Housing Crash

PEDRO NICOLACI DA COSTA

Public Policy Brief

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Preface

Levy Institute scholars have recently published many articles that outline the imbalances in the U.S. economy, analyze the instability in the financial markets, and conclude that a prolonged crisis is imminent in the absence of adequate policy interventions. This brief by Pedro Nicolaci da Costa continues the discourse by focusing on the actions of the Federal Reserve during asset bubbles. He finds that central bankers who accept self-policing as a basis for sound regulation are setting the global economy up for a real disaster.

The author notes that the “Big Banks” only react when asset bubbles burst, thereby creating a self-perpetuating cycle of perverse incentives and moral hazard that gives rise to subsequent bubbles. Contrary to the Fed’s current premise that policymakers cannot and should not target asset bubbles, recent experience has bolstered the view that asset prices must become part of the central bank’s purview in order to stabilize the economy. The prevailing belief that bubbles are impossible to spot ahead of time is untrue, because the housing market crash has been a train wreck in slow motion. There was plenty the Fed could have done to discourage speculative behavior and stop predatory lending. Furthermore, attitude changes among regulators are more important than shifts in mandate in ensuring that regulatory bodies like the Federal Reserve do their job properly.

Rather than talking down the frothy housing and mortgage bond sectors, the Fed failed to employ its most effective policy tool: the power of persuasion. Under Alan Greenspan’s leadership, it embraced fads like the “new economy” and “financial innovation” (e.g., securitization) that were little more than euphemisms for overvalued stock and home prices. The Fed’s most egregious failures as a regulatory body were its willingness to embrace these fads, its approval of a runaway process of credit creation, and its enabling of excess risk taking and fraud in the mortgage market. As a result, Greenspan presided over the most reckless debt binge in history.

The housing and credit crisis forced the Fed to slash interest rates and pump vast sums of liquidity into the financial system—measures that led to speculative excesses in the commodities markets. Thus, the greatest expansion of credit in modern history was ultimately regressive, because it trapped its poorest and most fragile recipients in a vicious cycle of personal indebtedness that could take decades to unwind. The Fed's willingness to feed the borrowing frenzy ultimately deprived some of the world's vulnerable populations of basic resources as a result of subsequent price hikes in the cost of nondiscretionary goods like food and fuel. (The food riots of the past year have revealed the dark underbelly of global interconnectedness.) Inflating and reflating asset bubbles is no way to run a stable economy in the long term.

The sheer magnitude of the housing and debt crisis offers a unique opportunity for the Fed to reconsider its view that bubbles remain outside its policy mandate. The problem requires proactive solutions by a federal government that recognizes the need for greater regulatory scrutiny in spite of a pervasive ideological aversion to regulation. Evidence suggests that regulation often enhances business confidence because it provides a set of ground rules that are determined with broader social interests in mind. Improved regulatory oversight would enhance policymakers' ability to fend off financial instability before it reaches crisis levels and threatens to engulf the entire (global) system.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*

September 2008

Shaky Foundations

Happier Days

Human nature and political pressure make it difficult for central banks to put the brakes on economic activity when the going is good. But in the end, a bursting asset bubble inevitably requires central bank action, usually when it is already too late and with adverse spillover effects. In this sense, the Federal Reserve (Fed) and other central banks already target asset prices. Yet, by taking aim at them only on the way down, the “Big Banks” create a self-perpetuating cycle of perverse incentives and moral hazard that often gives rise to yet another round of bubbles.

The housing market crash has been a train wreck in slow motion. Predictions of an eventual day of reckoning were widespread, and the warning signals were ubiquitous: price charts showing home values rising impossibly into the stratosphere; the growing practice of second and third home purchases as investment properties; late-night infomercials professing a million easy ways to make millions in real estate; and Wall Street’s increasing reliance on housing-backed bonds for its record-setting profits.

To be sure, bubbles are best perceived with the benefit of hindsight, a point that Fed policymakers have continually stressed (Kohn 2006). But the housing story has rendered untenable the prevailing belief that they are impossible to spot ahead of time. A predictable crisis is a preventable one, and it has become abundantly clear that there was plenty the Fed could have done to discourage speculative behavior and put a stop to predatory lending.

While such an approach is largely discouraged in both conventional wisdom and the prevailing academic literature, recent U.S. experience has bolstered the view that asset prices must enter the central bank’s purview in order for the economy to retain some semblance of stability. Former Fed Chairman Paul Volcker (2008) recently called for a broader regulatory role for the central bank in light of the housing-centered credit crisis.

Indeed, Treasury Secretary Henry Paulson's latest plan for tackling the crisis involves giving the Fed vast new authority to regulate investment banks, not just depository institutions. However, this paper will argue that attitude changes among regulators will be even more important than shifts in mandate in ensuring that regulators like the Fed do their jobs properly.

The U.S. central bank's current premise is that policymakers cannot and should not target asset bubbles. They are unable to do so, it is argued, because bubbles are impossible to spot until it is too late. They should not do so because taking action, particularly through tighter monetary policy, could unnecessarily derail healthy sectors of the economy.

"After more than a half-century observing numerous price bubbles evolve and deflate, I have reluctantly concluded that bubbles cannot be safely defused by monetary policy or other policy initiatives before the speculative fever breaks on its own," Alan Greenspan (2007) wrote in an editorial piece published in the *Wall Street Journal*.

This line of thinking, often regurgitated by sitting Fed officials, is shaky on both counts. Asset bubbles have become increasingly obvious. Greenspan himself spotted the stock bubble well in advance of its peak, famously accusing the markets of irrational exuberance in 1996. Later, though, he wholeheartedly embraced the fad of a "new economy" and talk of an American "productivity miracle."

The housing bubble was even easier to spot, and was widely predicted by a number of analysts—though these observers were often typecast as downbeat doomsayers in an otherwise rosy financial universe (Schenker 2004, Schiff 2005). Not that it took very scrutinous analysis to figure out what was happening. The barrage of late-night get-rich-quick housing schemes on television, as well as a number of regular programs devoted to everything from home improvement to the actual act of "flipping" houses, offered plenty of pointers to even the unskilled eye.

Innovation, Exploitation

Nowhere is the very real human impact of the sort of reckless lending practices that can arise at the hands of an excessively laissez-faire central bank more evident than in the United States. Here, it is important to keep in mind the other side of the lending ledger—the borrower. Not only were

dubious lending habits mislabeled by lenders as “innovation” that would improve access to credit for the underclass, but the Federal Reserve also fully bought into this line, with disastrous consequences. This gave business sectors as shady as used car sales the stamp of officialdom that prevented a broader questioning of potential hazards, including what might happen when variable-interest-rate loans reset at new and increasingly unaffordable heights.

There is a fine line between ranking credit risks and exploiting the poor. In a strictly hands-off regulatory system, the former inevitably morphs into the latter. This is what has happened in the United States. The greatest expansion of credit in modern history was ultimately regressive, because it trapped its poorest and most fragile recipients in a vicious cycle of personal indebtedness that will take years, if not decades, to unwind. Consumer credit outstanding, currently at \$2.5 trillion, now represents nearly one-fifth of gross domestic product. This is a problem that will not go away of its own accord, and requires proactive solutions by an engaged federal government.

The Fallacy of Affordability

The greatest misconception surrounding the emergence of the subprime mortgage sector, widely accepted by policymakers and politicians alike, is that it was a natural extension of the dream of American ownership, a way to make credit more broadly available to those with lower incomes and shakier credit histories. The reality was very different. What subprime loans did, in retrospect, was make housing *less* affordable by artificially inflating home prices in many parts of the country, thereby putting a home out of reach for many poor and middle-class Americans. And for those households that did manage to secure a mortgage, the pricing and interest rate structure was ultimately prohibitive, a fact all too apparent now that U.S. foreclosures have reached crisis levels.

What is striking from a policy standpoint is that the Fed not only stood idly by as many experts argued that both the housing and securitization booms had gotten out of hand, but it also actively encouraged speculation by touting the advent of real estate derivatives as a milestone in “financial innovation.” Ironically, this overwhelming nod of approval was taking place even as Fed Chairman Ben Bernanke (2007) admitted that the securitization

process was diminishing the central bank's ability to influence the housing sector through interest rate policy.

In this context, it is important to ask whether giving the Fed increased regulatory authority over banks, as Secretary Paulson has proposed, will be enough to ensure that the grossly inadequate lending practices that came to pass in the housing sector do not return in a new form once the economy recovers from recession. A change of heart, it seems, is perhaps even more crucial to the efficacy of any regulatory regime than an express mandate.

Indeed, the Fed already had broad oversight over much of the banking sector and yet failed to exercise it, in large part because of an ideological aversion to government's meddling in the business of financial markets. But it was this very scepticism of regulation that laid the groundwork for much of the chaos that has ensued, both in housing and in banking (da Costa 2008c, Mayer 2008).

In order for any system to work properly, therefore, current Fed officials and their eventual successors must become convinced of the need for greater regulatory scrutiny. The housing debacle should go some way toward easing their aversion to a more hands-on approach.

What Bubble?

Following Greenspan's lead, Fed officials have adamantly argued that the central bank cannot and should not target asset bubbles. The central premise of this argument is that bubbles are impossible to spot until it's too late, and that preemptive action aimed at one particular sector—say, the housing or equity markets—unnecessarily risks derailing the broader economy. Yet the great American housing crash suggests this line of reasoning is specious at best.

In reality, Greenspan knew the U.S. stock market was heading for trouble during the 1990s, and very early on in fact. In housing, too, policymakers looked the other way despite ample evidence of excesses, including unprecedented price growth.

America's housing collapse casts serious doubt on the idea that asset bubbles are too elusive for policymakers to spot them in time. A number of economists and financial experts had long predicted that America's excess reliance on debt would end badly, and, in particular, that residential

construction and home prices appeared to have reached unsustainable levels (Schenker 2004, Schiff 2005). To be sure, this view did not infiltrate either the Wall Street consensus or the Federal Reserve's inner policy circle. But the warning signs were plenty. Loan-to-value ratios were going through the roof. Global perceptions of risk, as evidenced by credit spreads, had fallen to all-time lows. Home prices in coastal areas and states like Arizona and Nevada had doubled, even tripled, in the span of just a few years.

This brings us to the other major point of contention regarding the inclusion of asset prices in the policy calculus. Raising interest rates in the face of a sector-specific boom could impact negatively on healthy expansions in other areas, potentially compromising economic growth. This is not an unimportant concern for Fed officials, particularly since their policy goals, unlike those of some of their overseas counterparts, include both low inflation and maximum sustainable employment. This dual mandate makes U.S. central bank officials especially cautious about compromising an expansionary trend.

Yet the call for policymakers to begin paying closer attention to asset price bubbles should not be interpreted as a vote for concrete asset price targets. This has never been suggested with any seriousness. Any attempt to aim at, say, some ideal level in the Dow Jones industrial average or a particular median home price would likely prove not only cumbersome but also futile, and would surely have destabilizing macroeconomic repercussions.

Instead, improved regulatory oversight would enhance policymakers' ability to fend off financial instability before it reaches crisis levels and threatens to engulf the entire system. Globally, a growing number of central bankers—including those in England, Norway, Canada, and New Zealand—have also supported “leaning against” bubbles by gently tapping on the monetary brakes when signs of trouble begin to appear (Cardarelli, Igan, and Rebucci 2008).

American Mavericks

In this sense, U.S. policymakers have become increasingly isolated in their call for unequivocally rejecting asset prices as a driver of policy. This has been true despite the fact that their own economy offers perhaps the best case study for why bubbles should remain in the crosshairs of monetary officials if the transmission mechanism is to remain effective.

Home ownership rates in industrialized countries have risen sharply over the past three decades, boosting household wealth and enhancing purchasing power for many citizens. Until recently, the United States was the quintessential success story in this area, with the equity from rapidly rising home values lining the pockets of millions of middle-class families and underpinning the greatest uninterrupted spending boom in more than 50 years.

But recent developments have highlighted the dark side of this vaunted American dream. As the booming real estate business drove lenders to make increasingly risky loans, the excess supply of residential construction saturated the already lofty market. The popping of this bubble has given way to the most severe housing downturn in decades.

The housing sector is inextricably linked to debt. Mortgages are by far the largest loans taken on by families and individuals, and their invention has made ownership possible for millions who otherwise would have been unable to afford them. Yet, as in any market taken to its logical extreme, the desire to squeeze every last ounce of profit out of America's home-buying bonanza has ended in tears. Those actually crying are the families who were swindled into loans they could not afford, with deceptive and intentionally confusing pricing strategies fraught with hidden fees and unforeseen expenses.

The banking sector, too, is smarting from its own gluttony, feeling the pinch from the mortgage mess in the form of multibillion-dollar losses. Naturally, those losing billions are still left with millions, so their troubles can hardly be stacked against the plight of a family facing imminent foreclosure on their home. Nonetheless, the impact of the housing slump on financial institutions is likely to have profound implications for economic growth in coming years, if not decades. With the tacit consent of regulators, lending became so irresponsible that prudent borrowing has also been threatened, with wide-ranging repercussions for both consumers and businesses.

Under Greenspan's leadership, the Federal Reserve quietly abandoned its mandate as a detached economic arbiter and took on more of a cheerleading role, embracing fads like the "new economy" and "financial innovation" that later turned out to be little more than euphemisms for overvalued stock and home prices.

Even as the housing bubble neared its apex, Greenspan (2005) played down its existence and possible adverse effects. "Although we certainly cannot

rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macroeconomic implications,” Greenspan told Congress. “Nationwide banking and widespread securitization of mortgages make it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections.”

The Fed also failed to raise any red flags regarding the reactive nature of credit rating agencies, an especially flagrant omission given their proven inability to spot earlier crises like Argentina’s bond default. It was the backing of the rating agencies that allowed for the broad spreading of subprime securities, since triple-A ratings were seen as basis enough for inclusion of real-estate securities in safety-seeking, conservative portfolios.

During his 18-year tenure, Greenspan’s ultimate fear was that he would be seen as the party-spoiler. Ironically, this very reticence has earned the former Fed chairman his place in modern economic history as the man who presided over the most reckless debt binge in history.

Words: Mightier Than Rates

Not only did the Fed not flex its regulatory muscle in anticipation of the subprime mess, but it also failed to employ what is arguably its most effective policy tool: the power of persuasion. Rather than talking down the frothy housing and mortgage bond sectors, the Fed touted them as beacons of cutting-edge financial progress, tools that successfully allowed for the spreading of risk, thereby raising the amount of capital available for investment. Never mind that the concept of spreading risk would likely have sounded both impetuous and imprudent to a medical doctor.

The Fed’s own words might indeed have proven mightier than its more tangible policy tools, if only they had been employed soon enough. By making clear that it was honing in on housing as a potential arena for trouble, a more vocal Fed would have had an immediate dampening effect on the market, effectively preempting any need for emergency measures—and, potentially, even the emergency itself. Such a policy focus might have come about in the form of a working group task force, comprising actors from government, industry, and academia. By airing out differing views in such a manner, the central bank would have sent a clear signal to those involved

in the mortgage arena that egregious acts of deception and fraud would be highly scrutinized, and not the least bit tolerated.

Such steps might also have gone some way toward bringing to light the dubious practices that have since been unmasked: loans made with little or no proof of income; the steering of minorities into variable-rate loans, even those families who could have qualified for fixed-rate mortgages (Gershberg 2008); purely speculative purchases of investment properties for which the cost of foreclosure was lower than that of holding the loan to maturity; and the outright falsification of documents, sanctioned by the very commercial banks that the Fed was supposed to be regulating (da Costa 2008b).

One of the Fed's most egregious failures as a regulatory body—and ultimately as a law enforcement agency—was its willingness to embrace new fads in the financial sector without scrutiny or independent analysis. In the latest crisis, asset securitization was welcomed as an unequivocal good. Policymakers paid little or no attention to its possible downside risks. In fact, the central bank repeatedly stated that the ability to securitize things like mortgages and car loans, by “spreading risk,” would ultimately prevent the emergence of a crisis.

The Fed had no business touting securitization—its job, in fact, was to be suspicious of newfangled financial products that even Wall Street investors themselves had a difficult time explaining. In doing so, the central bank gave a runaway process of credit creation its unequivocal approval, becoming a *de facto* enabler of excess risk taking and, in many instances, fraud (Black 2008).

Self-Imposed Limitations

One of the Fed's primary arguments as to why it was unable to stem the boom-bust of housing is that so much of the business of lending was now taking place outside of its traditional realm of scrutiny. In the so-called “shadow banking system,” enormous capital flows were now emerging from investment banks and hedge funds, neither of which policymakers had any legal control over.

However, this argument is difficult to accept, if for no other reason than the Fed never lamented this lack of regulatory authority until after the crisis was already well under way (Geithner 2008). Had it done so, such

explicit attention might again have acted as a moderate drag on a sector that looked to be getting out of hand—just the sort of low-impact approach, incidentally, that policymakers have suggested they favor.

“The Fed, after all, had broad powers to supervise commercial banks, and many of them still had deep trouble with subprime and attendant write-offs,” writes Milton Ezrati (2008), a senior economist and market strategist at money management firm Lord Abbett. Even recognizing this, Ezrati’s research reflects America’s phobia of regulation: “The danger, as in past regulatory frenzies, is that the regulators go too far, the way they did with Sarbanes-Oxley, or worse still, that they will try to turn back the clock on the financial innovations of past years.”

The Rising Toll of Bubble Madness

The U.S.-led cycle of bubbles, whose global impact has been increasing over the past two decades, seems far from over. Events that most investment models predicted should only happen every hundred years seem to be occurring at least once a decade, and the intervals between them appear to be narrowing.

The housing and credit crises have forced the Fed not only to slash interest rates sharply, but also to pump vast sums of liquidity—in excess of half a trillion dollars—into the financial system. This is of course an appropriate response if, in the judgment of policymakers, it might prevent broader economic dislocations like a prolonged recession.

However, there is ample evidence that these measures are already leading to speculative excesses elsewhere. This time, though, rather than lifting the middle class in the United States and other nations, as the ascent of housing prices did, the latest boom is taking place in an area that is likely to exact an even greater toll on the more fragile pockets of the consumer population: commodities.

The Fed’s actions on both rates and liquidity have exacerbated the U.S. dollar’s precipitous descent. But in the process, they have also lifted the price of oil, gold, and other commodities to unprecedented heights. This is the acumen of regressive central banking, because the rise in these prices has an immediate and discernible effect on some of the most vulnerable sectors of the population, in the form of spikes in the cost of nondiscretionary

goods like food and fuel. “Now they are throwing a lot of liquidity out, (but) it’s going to food and energy,” says Lakshman Achuthan, managing director of the Economic Cycle Research Institute and member of the Levy Institute’s Board of Governors. “This non-discretionary consumer spending makes up the lion’s share of the low-income consumer’s budget. So the Fed is trying to help out, but it’s really hurting the low-income consumer” (da Costa 2008a).

The Next Bubble May Be Deadly

Those looking for proof that bubbles have become increasingly easy to spot in a highly levered financial world need look no further than this year’s spike in commodity costs. Oil prices soared to record highs approaching \$150 a barrel last month before tumbling back to earth as it became clear that global demand would falter. Gold has raced past the \$1,000 per ounce mark. Other metals, including industrially key copper and steel, have followed suit.

Yet the severity of these developments pales in comparison with what was arguably the most dangerous bubble of all: food. By sheer speculation and with only moderate relationship to the basic laws of supply and demand, the price of everything from wheat to soybeans skyrocketed just as the U.S. credit crisis began, leading to food shortages and riots in several of the world’s poorer nations. In this perverse manner, the industrial world’s gluttonous appetite for credit and consumption—and the Fed’s unflinching willingness to feed the borrowing frenzy—has deprived some of the most vulnerable populations on the planet of basic resources that were already scarce to begin with.

In a global financial marketplace, these trends simply cannot be isolated from the policies of the world’s top monetary authorities (Rojas-Suarez 2008). Massive cash injections totalling in the trillions of dollars, from the Fed, the European Central Bank, the Bank of England, and others, visibly funneled a new burst of liquidity into the commodities sector, the only arena seemingly untouched by the U.S. housing crisis and related credit woes. The results proved catastrophic and, in some cases, lethal.

Food riots from the Caribbean to parts of Africa revealed the dark underbelly of global interconnectedness. Unimaginably, food shortages

extended even to the United States, with retail giant Wal-Mart announcing in April that it was limiting sales of several types of rice (Maestri 2008).

While U.S. citizens, unlike those of Haiti or Madagascar, will probably never face such extreme consequences as widespread food shortages as a result of market excesses, they are in fact already paying a price, not only because of what now looks like an inevitable recession, but also due to budding inflation pressures that many fear will persist over the next two decades. Former Fed Chairman Paul Volcker, credited with reining in the runaway inflation of the 1970s with then-unpopular interest rate increases, recently argued at a Harvard Club forum in New York that, while the current outlook cannot be compared to the 1970s as a whole, it does bear some resemblance to the outset of that difficult decade (Volcker 2008).

Over the past month, softer economic growth in Europe and Japan has taken the edge off commodity prices, leading to a sharp reversal in those markets. However, even a brief run-in with food shortages should be enough to illustrate a basic point: inflating and reflating asset bubbles is no way to run a stable economy in the long run.

Overcoming Regulation-phobia

America's housing crisis is emblematic of an ideological aversion to regulation that has culminated in a Wild West approach to the business of lending. In this environment, the result of two decades of deregulation, all bets were off when it came to promoting sound business and risk-management practices. The world's preeminent financial firms were all complicit in engaging in highly leveraged speculation in areas that showed clear signs of overvaluation.

The industry's incentive structure was such that a pressure to produce ever more massive quarterly profits became a primary guiding principle of decision making. The insulation of upper management from any serious potential for personal financial losses gave rise to a perverse tendency to look the other way on dubious deals. As long as they continued to yield short-term results, structured financial products that were packaged and repackaged in countless forms, however opaque, were the securities du jour. Everybody had to have a piece. The actions of top executives became so deeply detached from the long-term interests of their respective firms, in fact, that

banks continued to chase these securities even as their value plummeted, like reckless gamblers chasing losses at a casino table (Krugman 2007).

Yet, rather than providing a compass for solid underwriting standards and reasonable lending practices, the Federal Reserve not only turned a blind eye to increasingly shady behavior in the U.S. mortgage market but also egged on the sector's explosive growth, hailing securitized bonds as symbols of innovation that allowed credit to become more widely accessible. Believing in the self-correcting power of markets, Greenspan, Bernanke, and their colleagues allowed market forces to run their unfettered course, with disastrous consequences for the U.S. and global economies.

Just months before the credit crisis erupted, Bernanke (2007) went on the record defending deregulation and warning against the possible toll of enhanced rules. "How best to respond to these daunting challenges? As I noted, there are powerful arguments against ad hoc instrument-specific or institution-specific regulation. The better alternative is a consistent, principles-based, and risk-focused approach that takes account of the benefits as well as the risks that accompany financial innovation," he told participants of the Atlanta Federal Reserve Bank's Financial Markets Conference.

Red Tape or Rule of Law?

Experience suggests that regulation often enhances rather than detracts from business confidence, despite cries to the contrary from the nation's various chambers of commerce. Companies listing their shares on American exchanges, for instance, are often viewed in a more positive light by prospective investors, because they are seen as being subjected to tighter regulatory and accounting standards than their counterparts listed elsewhere.

Then there is the question of prevailing economic philosophy, which tends to associate regulation with inefficiency and cumbersome bureaucracies. Advocates of a more stringent financial code say this is a misguided way to think about the government's role. After all, it is the rule of law that lends the financial system the legitimacy that gives investors enough comfort to take risks. Regulation hawks argue that having a basic framework for proper behavior is just the sort of confidence-booster that current market conditions sorely lack. The widespread consensus that generally advocates minimal or "light touch" regulation will not be overturned overnight. But at the

very least, the scope of recent troubles and the prospect of an even deeper slump could nudge the Fed toward a more hands-on approach.

Regulation does not just mean red tape. It means abiding by basic rules of conduct that actually enhance the business of finance by surrounding it with a sense of confidence and stability—just what it sorely lacks under current conditions. In modern economics, regulation is essentially frowned upon as a superfluous business cost and an obstacle to open trade. But the rule of law should not be equated with red tape. Regulation simply provides a set of ground rules for business, rules determined with broader social interests in mind. In reality, a basic framework for proper behavior endows businesses like finance with a sense of legitimacy and stability—just what is sorely lacking under current conditions.

Uncentral Bank: The Implications of Eroding Confidence

The Fed has greatly diluted its own relevance by embracing the role of financial cheerleader. Repeatedly, it has proven behind the curve in both spotting and reacting to asset crises, and has been forced to scramble with rapid rate cuts, contributing to uncertainty and exacerbating market volatility. By warming up to the notion that asset bubbles pose an a priori danger to economic and financial stability, the Fed would go some way toward reversing the lack of confidence in its ability to stabilize the U.S. economy. This is crucially important, since a weaker Fed could lead to a reinforcement of market excesses that are now pushing the global economy into recession.

The sheer magnitude of the current housing and debt crises offers a unique opportunity for the Fed to reconsider its long-held view that bubbles should remain outside the policy radar. Minneapolis Federal Reserve Bank President Gary Stern (2008) indicated his own willingness to do so in a recent speech at the European Economics and Financial Centre in London. “While I have not yet changed my opinion that asset-price levels should not be an objective of monetary policy, I am reviewing this conclusion in the wake of the fallout from the decline in house prices and from the earlier collapse of prices of technology stocks.”

With bank losses totalling over \$200 billion, a tally that the International Monetary Fund has estimated may quintuple when all is said and done, and the economy facing the possibility of an unusually severe recession

(Krasny 2008), the time has indeed become ripe for a reevaluation of the central bank's approach.

Cardarelli, Igan, and Rebbucci (2008) have found that, for countries with more intricate mortgage systems where complex financial channels can have a broader macroeconomic impact, it may be wise for policymakers to respond more aggressively to national housing trends. In their study of several major economies, the authors discovered that “innovations in housing finance systems have increased the scale of spillovers from the housing sector to the general economy and that housing seems to be particularly important in the monetary transmission mechanism in countries with more developed mortgage markets.”

Beyond the realm of monetary policy, the need for better regulatory tools employed in conjunction with a vigilant monetary mechanism have found growing acceptance in both scholarly and policy circles (Borio and White 2004). Bernanke (2008) himself has called for an overhaul of the country's fragmented regulatory structure in recent congressional testimony.

Jane D'Arista (2008) recommends the creation of a new reserve management system that gauges reserves against assets rather than deposits, thereby acting as a more targeted brake on credit than traditional monetary policy. This seems like a reasonable approach, although its repercussions lie outside the scope of this paper.

Whatever the specifics of day-to-day monetary operations, prudent policies will only come from policymakers who have honed their regulatory antennas in such a way as to both spot asset bubbles and address them. In a global economy where constant growth is viewed as an unequivocal good, this may be a difficult approach to implement. But as the U.S. housing and financial crises so clearly indicate, central bankers who accept self-policing as a basis for sound regulation are setting the global economy up for a real disaster.

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